OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR [redacted]

FROM: STEVEN J. HANKIN
CHIEF, CORPORATE BRANCH
FIELD SERVICE DIVISION CC:DOM:FS

SUBJECT: Loss Deferral under I.R.C. § 267

This Field Service Advice ("FSA") responds to your memorandum dated August 25, 1998, supplementing an FSA issued July 25, 1997. Two additional FSA's were issued on October 7, 1997 and June 23, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

P =
S1 =
S2 =
S3 =

F1 =
F2 =

X =
Y =

$a =
$b =

$c =
$d =
$e =
$f =
$g =
A$h =
A$i =
A$j =
A$k =
A$m =
$n =
A$o =
A$p =
A$q =
A$r =
$s =
$t =
$u =
$v =

aa =
bb =

Date 2 =
Date 3 =
Date 4 =
Date 5 =

Year 1 =
Year 2 =

Country X =

ISSUES:

1) Whether the P group correctly applied the basis shifting rules of I.R.C. § 267(f) in determining S3's loss on the sale of the F2 stock to X?

2) Whether the Service can assert the application of I.R.C. § 269 to S3's acquisition of the F2 stock.

CONCLUSIONS:

1) The P group correctly applied the basis shifting rules of I.R.C. § 267(f) in determining S3's loss on the sale of the F2 stock to X.

2) The Service cannot assert the application of I.R.C. § 269 because the control requirement is not satisfied.

FACTS:

During the year at issue, P was the common parent of an affiliated group of corporations filing a consolidated Federal income tax return. P owned all of the stock of S1, which owned all of the stock of S2, which owned all of the stock of S3. S1, S2 and S3 were all members of the P consolidated group.

S3 owned all of the stock of F1, which owned all of the stock of F2. F1 and F2 are each Country X corporations.

On Date 2, the following steps took place:

1) S1 contributed $c to the capital of S2, which contributed this money to the capital of S3, which borrowed $d (from S1) and used $e[1] to purchase A$h.

2) S3 contributed A$i (of the A$h it received from S2) to the capital of F1 in exchange for aa shares of A$1.00 par value F1 stock. This exchange qualified as tax-free under I.R.C. § 351 and increased S3's basis in F1 by A$i or $a.

3) F1 contributed the A$i, plus A$j of its own funds (for a total contribution of A$k), to the capital of F2 in exchange for bb shares of Class B A$1 convertible redeemable preference shares. This exchange qualified as tax-free under I.R.C. § 351 and increased F1's basis in F2 by A$k.

4) F1 sold F2 to S3 for A$m ($n) and realized a loss of A$o, which was deferred under I.R.C. § 267. However, you believe that this deferred loss became part of S3's basis in F2, pursuant to Temp. Treas. Reg. § 1.267(f)-1T(c)(6) & (7), when S3 sold F1 to X on Date 4 (see below).

5) S3 contributed A$p (the difference between the A$h it received from S2 and the A$i it previously contributed to F2, through F1) to the capital of F2. Thus, S3

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[1] We note that this amount of $e is less than the total amount of $f that S3 received or borrowed ($c + $d). The difference of $g ($f - $e) is not accounted for, although it may have represented the cost of purchasing the Country X dollars.

directly and indirectly contributed the entire A$h it received from S2 to the capital of F2.

On Date 4, S3 sold the stock of F1 to X for $s. P claimed a long term capital loss of $b on its consolidated return for the year ending Date 5, of which $t was deducted. The remainder ($u) was carried back to the Year 1 tax year and fully utilized.

In Year 2, S3 sold F2 to Y and again realized a loss of approximately $v attributable, in part, to the basis adjustment reflecting F1's deferred loss on the sale of F2, which increased S3's basis in F1 by such amount under I.R.C. § 267(f). This loss was utilized on P's consolidated return.

You have asked whether the P group correctly applied I.R.C. § 267.

I.R.C. § 267:

LAW AND ANALYSIS

Law:

I.R.C. § 267(a)(1) provides that no deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of I.R.C. § 267(b).

I.R.C. § 267(b)(3) provides that the persons referred to in I.R.C. § 267(a) are two corporations which are members of the same controlled group (as defined in I.R.C. § 267(f)).

I.R.C. § 267(f)(1) provides that for purposes of this section, with exceptions not relevant here, the term "controlled group" has the meaning given to such term by I.R.C. § 1563(a).

I.R.C. § 267(f)(2) provides that in the case of any loss from the sale or exchange of property which is between members of the same controlled group and to which I.R.C. § 267(a)(1) applies, I.R.C. § 267(a)(1) shall not apply, but such loss shall be deferred until the property is transferred outside such controlled group and there would be a recognition of loss under consolidated return principles or until such other time as may be prescribed in regulations.

Treas. Reg. § 1.267(f)-1T(a)(3) provides that Treas. Reg. § 1.267(f)-1T applies to a loss on the sale of property between two members of a controlled group that do not join in filing a consolidated return for the taxable year the loss is incurred.

Treas. Reg. § 1.267(f)-1T(b)(1) provides that the term "group" means "controlled group". The term "controlled group" is defined in I.R.C. § 267(f)(1). Thus, excluded members referred to in I.R.C. § 1563(b), such as foreign corporations, are not excluded from a group.

Treas. Reg. § 1.267(f)-1T(b)(2) provides that the term "member" means a corporation included in a controlled group.

Treas. Reg. § 1.267(f)-1T(c)(1) provides that, except as otherwise provided in this section, the rules for deferred intercompany transactions in Treas. Reg. § 1.1502-13 apply under I.R.C. § 267(f)(2) to the deferral and restoration of loss on the sale of property directly or indirectly between the selling member and the purchasing member as if

> (i) the taxable year in which the sale occurred were a consolidated return year (as defined in Treas. Reg. § 1.1502-1(d)) and
>
> (ii) all references to a "group" or an "affiliated group" were to a controlled group.

Treas. Reg. § 1.267(f)-1T(c)(6) provides that if a selling member of property for which loss has been deferred ceases to be a member when the property is still owned by another member, then, for purposes of this section, Treas. Reg. § 1.1502-13(f)(1)(iii) shall not apply to restore that deferred loss and that loss shall never be restored to the selling member.

Treas. Reg. § 1.267(f)-1T(c)(7)(i) provides that if Treas. Reg. § 1.267(f)-1T(c)(6) precludes a restoration for property, then on the date the selling member ceases to be a member, the owning member's basis in the property shall be increased by the amount of the selling member's unrestored deferred loss at the time it ceased to be a member.

Treas. Reg. § 1.267(f)-1T(c)(7)(iii) provides that the owning member's holding period for the property shall be increased by the selling member's holding period.

Analysis:

F1's loss on the sale of the F2 stock to S3 was properly deferred under I.R.C. § 267(f)(2). That provision provides an exception to the normal rule of I.R.C. § 267(a)(1), which disallows a loss resulting from a sale of property between related persons. Instead, under I.R.C. § 267(f)(2) such a loss is deferred if the sale occurs

between members of a controlled group and if I.R.C. § 267(a)(1) would otherwise apply. Under Temp. Treas. Reg. § 1.267-1T(b)(1), a controlled group includes foreign affiliated corporations. Thus, F1 and F2 are considered members of the P controlled group for purposes of applying the deferral rules of I.R.C. § 267(f).

Under the normal deferral rules of Treas. Reg. § 1.267(f)-1T(c)(1), the deferred intercompany transaction rules of Treas. Reg. § 1.1502-13 (as in effect prior to July 12, 1995, i.e., the effective date of new Treas. Reg. § 1.1502-13) apply to the deferral and restoration of loss on the sale of property between members of a controlled group.

Under these rules, the loss incurred by F1 upon the sale of the F2 stock to S3, which was deferred, would normally be restored to F1 when it left the group on Date 4 (when it was sold by S3 to X). Treas. Reg. § 1.1502-13(f)(1)(iii). However, Temp. Treas. Reg. § 1.267(f)-1T(c)(6) provides that this restoration rule shall not apply. Instead, S3's basis in the stock of F2 is increased by the amount of the deferred loss that was not restored to FI. Temp. Treas. Reg. § 1.267(f)-1T(c)(7)(i). Therefore, such loss would be claimed by the P group when S3 sold the F2 stock to Y. In other words, the P group properly applied the deferral and restoration rules of I.R.C. § 267.

I.R.C. § 269:

LAW AND ANALYSIS:

Law:

Section 269(a)(1) provides that if any person acquires, directly or indirectly, control of a corporation and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance.

Analysis:

In this case, S3 directly acquired control of F2, by purchasing all of its stock. Therefore, the first requirement of I.R.C. § 269(a)(1) appears to be satisfied. We note, however, prior to the sale, S3 indirectly owned all of the F2 stock (through F1).

The legislative history of the predecessor of I.R.C. § 269 states as follows with respect to the acquisition test:

> If a controlled or affiliated group existed on [the effective date of the provision], transfers thereafter within the group could not amount to the acquisition of such control by the parent or its controlling interest. Control once acquired could not again be acquired, unless the group were in some way broken. A mere shift in the form of control - from direct to indirect, from indirect to direct, or from one form of indirect to another form of indirect - can not, therefore, amount to the acquisition of control within the meaning of [the provision].

Sen. Rep. No. 627, 78th Cong., 1st Sess., pp. 60-61 (1943), 1944 C.B. 971, 1017.

Therefore, S3's purchase of the F2 stock can not meet the definition of control within the meaning of I.R.C. § 269 since S3 indirectly controlled F2 prior to the sale. In addition, the legislative history further discusses transfers within a controlled group, as follows:

> If instead of shifting the stock of a subsidiary nearer the parent as in a [I.R.C. § 332] liquidation, it is transferred farther down the chain of subsidiaries [,] it is clear that these subsidiaries farther down the chain (but not the parent or the subsidiaries up the chain) do acquire control of the shifted subsidiary.

Id. at 1944 C.B. 1018.

Since the shift in this case is up the chain and not down the chain, the legislative history is clear that the I.R.C. § 269 control requirement cannot be satisfied in this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS: